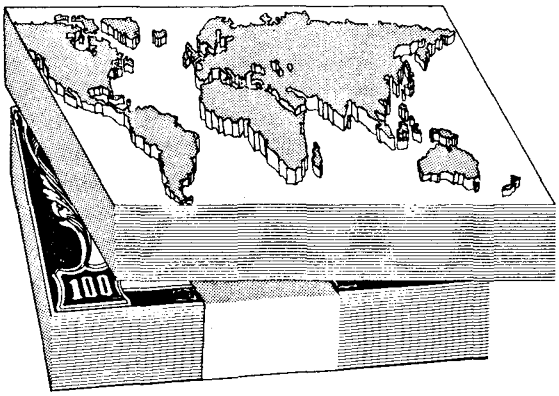
Love, Jim and Ashcroft, Brian and Brooks, Richard and Dourmashkin, Neil and Draper, Paul and Dunlop, Stewart and Lockyer, Cliff and Magee, Lesley and Malloy, Eleanor and McRory, Eric and Monaghan, Claire and McGregor, Peter and Perman, Roger and Stevens, Jim and Swales, Kim (1989) The world economy [December 1989]. Quarterly Economic Commentary, 15 (2). pp. 3-5. ISSN 0306-7866 ,

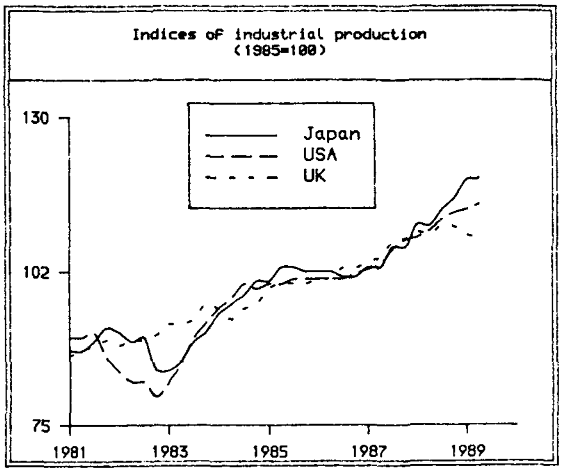
The World Economy



Macroeconomic Trends

The seven largest OECD countries showed GDP growth, in real terms, of 0.35% in the second quarter of the year, approximately the same as for the OECD as a whole. France displayed the highest quarterly rise (0.6%), with West German output rising by half of that, and GDP in Japan falling by 0.9% in the second quarter (see Japanese economy below). These figures are indicative of the continuing slowdown in growth in the major industrialised countries, although there are still no clear signs of a descent into recession. Inflation remains as much of a threat as recession. In the twelve months to September the average inflation rate in the OECD was 5.0%, with the largest seven countries showing an average for the twelve months of 4.2%; the UK had the highest rate (7.6%) and Japan the lowest (2.6%).

Between April and June industrial production, which makes a substantial contribution to GDP, rose by 0.6% in the OECD countries. In the twelve months to August industrial production rose by 3.3% for the seven largest OECD countries. By individual country the growth rates for the twelve months to August were 5.8% in Japan, 4.6% in France, 3.1% in West Germany, 2.7% in the United States (year to September), 2.3% in Italy, 0.9% in the UK, and -0.4% in Canada.



Key developments in the three main OECD economies were as follows:-

United States

The rate of growth of real GNP continued to moderate in the third quarter of the year, growing at an annual rate of 2.5% in that period. This was accompanied by other indicators of a slow down in the US economy. In October the volume of retail sales fell by 1%, which was preceded by the virtual collapse of sales of new houses during August and September. Also in October industrial production fell by 0.7%, all of which point to the risk of recession being greater than that of inflation.

However, there are some indications that there may yet be need for caution before any relaxation of monetary conditions is contemplated. The official employment cost index, an inflation indicator, rose 1.6% in the third quarter of the year, compared with a rise of 1.1% in the second quarter. In addition, September saw a slight rise in the rate of inflation following a levelling off in August. The twelve month rate of inflation to September 1989 now stands at 4.3%. These factors may discourage the Federal Reserve Board from allowing any further falls in the prime lending rate, although such a move would, in addition to stimulating domestic demand, help to moderate the strength of the dollar and so contribute to improved trade performance.

As indicated in the last Commentary, there are now some indications of an improvement in the external deficit. In September the trade deficit fell to $7.9 billion, the lowest figure recorded for five years. This is largely due to the slowdown in the domestic economy, with its resultant reduction in demand for imported goods. The subsequent fall in retail sales mentioned above should further aid this process. The OECD now forecasts that GNP will grow by 3% in 1989 and by 2.5% in 1990, with inflation rising from 4.6% in 1989 to 4.7% in 1990.

Japan

Somewhat unusually for recent Japanese performance, real GNP fell by 0.8% in the second quarter following a very rapid rise in the first quarter. However, these figures were distorted by the imposition in April of the 3% consumption tax. Consumer expenditure, which accounts for 55% of GNP, rose very sharply in March in anticipation of the tax, and correspondingly declined in the following quarter.

Because of fears of inflation, the Japanese authorities have been nervous about boosting domestic demand in order to maintain the high growth levels of the recent past. Nevertheless, they have come under considerable pressure to do so, especially from the US authorities who are keen to see an improvement in the US trade deficit with Japan. Capacity utilisation is now very high, and employment has continued to fall to just 2.2% with relatively few vacancies. Capacity constraints coupled with continuing high company profitability have resulted in investment continuing to grow, although not nearly as strongly as in the recent past. Investment demand grew by 1.4% in the second quarter, an annual rate of 5.7% compared with an annual rate of 19.7% for the previous quarter.

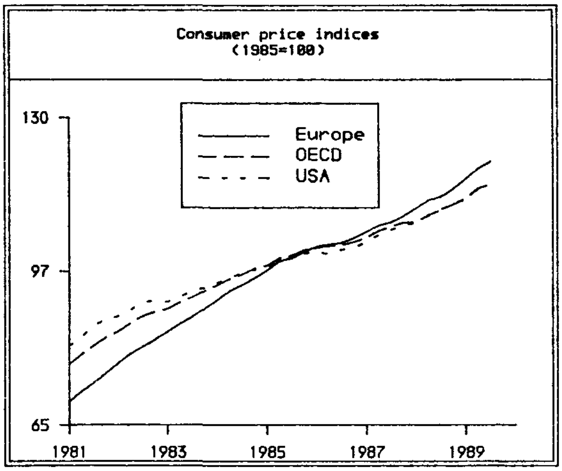
These worries over inflation persist despite some evidence which indicates a slight slackening in inflationary pressures. Wholesale prices fell by 0.6% in October compared with the previous month, a reversal of the steady upward trend of the previous eleven months. This monthly fall nevertheless leaves the year-on-year rise in wholesale priced at 3.3%. Consumer prices rose by 2.6% in the year to September, 0.3 percentage points lower than the 12-month rate in the previous quarter. Monetary conditions have tightened steadily during 1989 in an attempt to contain inflationary pressures, and further rises in interest rates cannot be ruled out if the Yen continues to weaken against other major currencies. Exchange rate movements have played a part in the steady decline in Japan's trade surplus. In the six months to September the trade surplus was $33.0 billion compared with $37.8 billion in the same period in 1988. There are worries, however, that the trade surplus may begin to rise again in the new year.

West Germany

West Germany has become the centre of attention in the OECD countries in terms of economic growth. For the first time since 1979 economic growth has exceeded that of the OECD as a whole. Over the first six months of 1989 GNP grew in real terms by 4.6%. Export performance remained strong in the second quarter, before the D-Mark began to strengthen relative to the dollar; exports now account for one-third of GNP, double the proportion of the mid-1970s. By contrast, domestic demand faltered during the second quarter; consumer expenditure remained unchanged from the first quarter, and investment fell by 2.9% in real terms. This fall was entirely due to a slowdown in construction activity - investment in plant and machinery rose by 7.9% in the quarter, an annual rate of 35.5%.

The relative weakness of the DM earlier in 1989 served to increase the size of the current account surplus, which rose to DM 67.6 billion by August. Despite the strengthening of the DM more recently, it now looks possible that a surplus of DM 100 billion will be recorded for the year, which would be 18% higher than in 1988.

Growth is still expected to exceed 3% in 1990, with the main concern continuing to be expectations of inflation. Consumer price inflation rose to 3.1% in the year to September, up from 2.9% in the year to August, and there is still the boost to consumer demand expected early next year from the DM 25 billion tax reform. Capacity utilisation is at its highest level for 18 years, and unemployment is now down to 2 million. The Bundesbank may, therefore, feel that there is still a need to allow interest rates to move a little higher. Another imponderable in the longer term is the likely impact of an influx of up to one million people from Eastern Europe. Ultimately this should reduce skills bottlenecks in certain areas as well as giving a boost to domestic demand; in the short-run, however, the demand-side effects of the immigrants should be very limited.



LABOUR MARKET

Standardised rates of unemployment stabilised in OECD countries in the second quarter of 1989, following a period of steady decline. The rate for the whole OECD was 6.2%, and for the G7 countries 5.7%, both unchanged from the first quarter.

Data are now available for the third quarter for all G7 countries except Italy, the country with the highest unemployment rate of the group. Small falls in the rate of unemployment are the norm; from 7.6% to 7.3% in the United States, down by 0.1% points in Japan and West Germany to 2.2% and 5.5% respectively, and unchanged in Canada (5.2%) and France (9.5%). In the UK in the third quarter unemployment fell from 6.6% to 6.2%.

PROGNOSIS

Growth continues to slow down in the leading industrialised countries in response to the tightening in monetary conditions in 1988 and early 1989. There is little to change the view expressed in the last Commentary that a path can be steered between recession and inflation - a global "soft landing". A growth rate for the OECD of around 3% is generally thought to be consistent with a desire not to fuel inflation, and forecast growth rates for 1990 and 1991 are now in the region of 3%. Growth in West Germany has been rather more buoyant than anticipated, and Japan is expected to continue to achieve steady growth following the hiatus experienced in the second quarter. There is now, however, some indication that the West German authorities may wish to see further tightening in monetary conditions as fears of inflation outweigh those of recession.

Although some concern was expressed during the September meeting of G7 countries about the strength of the dollar, rather more optimism about the prospects of an orderly slowing of economic growth was apparent at this meeting than of late. However, the recent falls in the trade surpluses of West Germany and Japan may be only temporary, and should they begin to rise again during 1990 we may once again hear of the problem of "fundamental imbalances".